CHAPTER 6: DETERMINATION OF PROJECT SUITABILITY

6.1 INTRODUCTION

When there are loan repayment or compliance problems with a project and the Agency is considering special servicing actions, or prior to making a subsequent loan, the Loan Servicer must determine that the project remains suitable as a program property. To remain a suitable project, there must be a need for the project and the physical property cannot be obsolete. If a project is suitable, it is in the best interest of the Government to proceed with the servicing action. However, if the Agency determines that a project is no longer suitable, the Agency may designate it as non-program rather than spend limited Agency resources on a project that does not fulfill the goals of the program.

This chapter is designed to assist the Agency and the Loan Servicer in particular, to make an analysis of a project's suitability and make a determination that meets the principles and objectives of the Agency. This chapter also provides guidance on implementing appropriate actions when a project is no longer suitable:

6.2 WHEN TO CONSIDER SUITABILITY

The Loan Servicer should conduct a suitability analysis when the borrower and project meet one of the following conditions.

- When there are loan repayment or compliance problems with a property and the Agency is considering special servicing, including a transfer or liquidation action; or

- When the borrower requests a subsequent loan.

There are exceptions to the conditions above that do not require the Loan Servicer to consider suitability.

- When a project is clearly suitable and there are no loan repayment or compliance issues that threaten the financial viability of the project, a suitability analysis is not necessary. For example, if the Loan Servicer is processing a limited review transfer, in accordance with Chapter 7, or the Loan Servicer has determined that there are no compliance violations or increased risks to the Agency, then there are clearly no suitability issues that require further analysis.

- When a borrower requests to prepay a loan the Agency should not conduct a suitability analysis. In this case, the Loan Servicer must proceed with the borrower in accordance with Chapter 15.

- When a case has been referred to the Office of General Counsel (OGC) or the U.S. Attorney for action, the Agency may not consider suitability. The Agency does not pursue actions separate from the legal actions of OGC or the U.S. Attorney.

6.3 KEY STEPS TO COMPLETING A SUITABILITY REVIEW

The Agency completes five major steps to move through the process of making a suitability determination and implementing the appropriate actions based on the analysis. The Loan Servicer has primary responsibility for the first three steps of conducting the analysis of need and obsolescence. If the initial analysis indicates that the property may not be suitable, the State Office, with assistance from OGC and the National Office as necessary, is responsible for the next two steps, in which a final determination of suitability is made and the resulting course of action is approved. These steps are listed in Exhibit 6-1.

Exhibit 6-1

Key Steps to Complete a Suitability Review

1. Analysis of ownership
2. Determination of need
   - A. Information gathering
   - B. Analysis
     - i. Impact on tenants
     - ii. Economic viability
     - iii. Impact on the community
   - C. Determination
3. Determination of obsolescence
   - A. Information gathering
   - B. Analysis
     - i. Health and safety
     - ii. Physical characteristics
     - iii. Need
   - C. Determination
4. Determination of suitability
5. Implementation of the suitability determination

If the primary suitability issue concerns obsolescence, the Loan Servicer must consider need to determine the impact on tenants. The amount of information and analysis needed to complete each step may be different. The appropriate type of review depends on the level of documentation the Agency has on file and the level of analysis required to make a final determination.

6.4 ANALYSIS OF OWNERSHIP

The analysis of project suitability must first consider the ownership of the property to confirm that it is acceptable. Key questions to answer include:

- Is the present ownership entity still legally operational?

- Is the ownership entity cooperative? (Is the ownership entity responsive to Agency requests for information and does it take action when the Agency identifies issues and deficiencies?)

- Is the ownership entity financially solvent?

- Is competent management being provided?

The answer to all four questions should be yes. If not, improvements must be made for a project to be deemed suitable.

6.5 DETERMINATION OF NEED

To make a determination of need, the Loan Servicer goes through a process of information gathering and analysis before making a determination of need.

A. Information gathering

The Loan Servicer should have the following information to determine need:

- The Agency should obtain a market study. If the Agency has a market study covering the project area that is less than 12 months old, the Loan Servicer may use this market study and update any information as necessary;

- If not included in the market survey, the Loan Servicer may need to obtain local economic indicators, such as local employment and economic trends to judge the short- and long-term prospects for change;

- The Loan Servicer should have the project's updated budget, including a record of accounts receivable and accounts payable;

- The Loan Servicer may ask the borrower to prepare documentation stating the borrower's intentions for the property and the proposed rents if it becomes a non-program property; and

- The Loan Servicer should also seek community input to get information on the community's interest in retaining the project and the community perception of the need for the project.

B. Analysis

There are two components to the analysis of need, impact and economic viability. The Loan Servicer must consider both components to determine if there is a need for a project.

1. Impact

The Loan Servicer must determine if a non-program designation would have a negative impact on tenants. This analysis is the same impact analysis as conducted in response to a prepayment request. See Chapter 15, paragraph 15.22 of this handbook for a detailed discussion on determining impact. The objective of this analysis is to determine if tenants will lose their units, suffer from rent overburden, or be unable to find comparable housing in the community.

The Loan Servicer should use the market study and proposed non-program rent information to consider the following:

- The tenant's ability to stay in the project. This analysis depends on the proposed use of the project after a non-program designation and conventional rents for comparable units;

- The availability of alternative housing if the proposed use of the project or increase in rents will cause rent overburden. The alternative housing must be comparable in size, amenities, and rent to keep project tenants in the local community; and

- If the project has rental assistance, the Loan Servicer must identify comparable units with rental assistance (RA) or other rental subsidies, such as HUD Section 8.

Exhibit 6-2 provides an overview of the full analysis of impact.

Exhibit 6-2

Analysis of Impact on Tenants

Step 1: Answer the following questions about rents and loss of units.

A. Will a non-program designation result in an increase in tenant payments, and, if so, will this new payment be higher than 30 percent of the current tenants' incomes?

OR

B. Will a non-program designation result in a loss of units?

If the answer to both A and B is no, there is no adverse impact on tenants.
If the answer to either A or B is yes, proceed to Step 2.

Step 2: Answer the following questions about the availability of alternative housing:

C. Are there sufficient comparable vacant units in the market area (as indicated by the market study) for displaced tenants to find alternative housing?

AND

D. Are the tenant payments in these units equal to or less than the greater of their current rent or 30 percent of their income?

If the answer to both C and D is yes, there is no adverse impact on tenants.
If the answer to either C or D is no, there is an adverse impact on tenants.

2. *Economic Viability*

The Loan Servicer must determine if the project is economically viable. If the property cannot generate sufficient income to pay essential expenses, fund accounts, and make loan payments—despite appropriate loan servicing actions, budgeting, and marketing—the property may no longer be economically viable. Economic viability problems are usually associated with a change in local economic conditions and the inability of the project to maintain a sufficient occupancy rate even with aggressive marketing. For example, if a 20-unit project has a 50 percent vacancy rate and has been steadily losing tenants as the area's population declines due to the closing of a factory, the property may not be economically viable. It may not be in the Agency’s interest to spend limited resources on a project that cannot meet the financial requirements of the program. Physical characteristics of a property that impact on viability are considered under obsolescence, but utilize the same basic analysis.

Types of questions to consider regarding economic viability include:

- Has the market changed due to changing demographics or local economic conditions such that there is no longer demand for the units?
- Is there a need for a different bedroom mix than the property has to offer?
- In the case of on-farm Labor Housing, is the operator still farming?
- Have there been significant vacancies that cannot be reduced with aggressive marketing?

To make the determination of economic viability, the Loan Servicer should:

- Determine whether the borrower’s budget, rents and marketing plans are appropriate in accordance with Chapters 4 and 7 of HB-2-3560.
- Determine that special servicing, including utilizing all appropriate workout tools in accordance with Chapter 10, and increased rental assistance, if available, will not allow the project to be viable. Any increase in rental assistance must be reasonable and approved in accordance with Chapter 8 of HB-2-3560. If the cost to the Agency of special servicing exceeds replacement costs—for example, a write down plus a subsequent loan is greater than new construction costs—the special servicing is not in the Agency’s best interest.
- Determine that, based upon the market study, local economic conditions will not significantly improve in the next one to two years. The market study should identify any known changes in the local economy to assist the Loan Servicer in understanding the short- and medium-term impacts. For example, if a new factory or large business is relocating to the local area, or has announced plans to close, these plans will affect the local economy.

- Determine that the borrower, given occupancy levels and any servicing actions, cannot pay essential expenses, adequately fund accounts, and pay the borrower's monthly loan payment in full.

If the Loan Servicer makes all these determinations, the project is economically unviable.

C. Determination

Based on the analysis concerning the need for the project, the Loan Servicer makes one of the following determinations:

1. If a non-program designation would have an adverse impact on tenants and the project is economically viable, then the project is needed.

2. If a non-program designation would <u>not</u> have an adverse impact on tenants and the project is economically viable, then the project is not needed. However, any resulting outcome of the suitability determination should not provide an undue financial reward to the borrower.

3. If a non-program designation would have an adverse impact on tenants and the project is <u>not</u> economically viable, then the project is not needed. However, the Agency cannot remove the property from the program until the Agency finds affordable and comparable housing for all the tenants.

4. If a non-program designation would <u>not</u> have an adverse impact on tenants and the project is <u>not</u> economically viable, then the project is not needed.

6.6 DETERMINATION OF SITE OR BUILDING OBSOLESCENCE

To make a determination of obsolescence, the Loan Servicer should go through the following process to determine if the property (i.e., the site and the building) poses a health or safety threat, has physical characteristics that cannot be addressed economically, or faces adverse local economic conditions. The Loan Servicer must also consider the issue of need when determining if a project is obsolete. The outcome of the need determination does not affect the result of the obsolescence determination, but it may influence how the Agency implements the result.

A. Information gathering

The type of information the Loan Servicer needs to determine if a property is obsolete depends on the nature of the suitability problem. In most cases, the Loan Servicer will need several of the following:

- Data on environmental conditions. The need for an environmental review, assessment, or due diligence is based on the condition of the property and must be conducted in accordance with RD Instruction 1940-G. Due diligence is to be accomplished prior to appraisal to assure that any adverse conditions are considered in valuation. In cases where contamination is found, the State Environmental Coordinator should be consulted on further actions;

- A physical inspection. The Loan Servicer and State Architect, if appropriate, may conduct a unit-by-unit physical inspection of the property with a cost estimate to fully understand the problem and to determine whether repairs or rehabilitation may resolve the problem;

- Market study. A market study is most appropriate when the problems are related to external factors. It is also necessary as part of the need assessment;

- Cost Estimate. A professional may be needed to determine the feasibility of repairs, and to obtain a cost estimate. The State Architect should be consulted for review of estimates;

- Cost estimates for new construction in the project's area. New construction cost estimates are critical to determine the Agency's financial interest; and

- Borrower's intentions. The Loan Servicer may ask the borrower to prepare documentation stating the borrower's intentions for the property and the borrower's proposed rents if it is designated non-program.

B. Analysis

There are three reasons a property may be considered obsolete:

- The property poses a health or safety risk to the tenants;

- The building has structural or design characteristics that make the project economically unviable; or

- The site is no longer economically viable because of local economic conditions (such as the transportation infrastructure).

The Loan Servicer must also determine that the problem either cannot be solved through special servicing, workout agreement, or a subsequent loan or that solving the problem is not in the Agency's best financial interest. Exhibit 6-3 lists helpful questions to use in making this determination.

Exhibit 6-3

Factors Influencing Obsolescence

Site

- Has economic obsolescence adversely affected the community?
- Does the community have adequate medical, transportation, and school systems?
- Is the site itself located in a solid residential neighborhood that is a viable part of the community?
- Does the site have frontage along at least one-fourth of the perimeter?
- Does the topography of the site lend itself to optimal accessibility?
- Does the site have environmental hazards or commercial influences that adversely affect it?

Building

- Is the building structurally sound?
- Are there obsolescence factors that are economically unfeasible to correct such as the building design, poor quality of construction, environmental hazards, or structural deterioration?
- Does a unit-by-unit inspection with cost estimate for rehabilitation, deferred maintenance, and wheelchair accessibility demonstrate that the costs of this work are not feasible in the project budget?
- Can the property be rehabilitated to bring it into compliance with applicable building codes or must an exception to code requirements be obtained from local authorities?
- What is the estimated economic useful life of the property after rehabilitation?

1. Health or Safety

Health or safety issues are most often identified or documented during a physical inspection or environmental assessment of the property. While a majority of violations can be fixed through maintenance, repairs, or even a subsequent loan to pay for rehabilitation, some violations are more difficult to resolve.

Any compliance violation that is identified on the physical inspection report may be classified as a health or safety issue. However, most of these violations will never lead to a concern of suitability. For example, broken windows, a leaking roof, or exposed wiring are all easily corrected if funds are available. Health or safety issues that do affect suitability will likely pertain to the entire project and either cannot be repaired, or repair is too costly. For example, a property with a damaged and unstable foundation may not be repairable or repaired at an expense beyond what is fiscally responsible.

2. Physical Characteristics

Physical characteristics that make the project obsolete or economically infeasible are usually documented either through a physical inspection or with a market study.

Example

For a project that may need on-site laundry facilities to improve the project's marketability, the borrower may be able to receive a subsequent loan for rehabilitation, if necessary, to resolve the problem; therefore, the property is not obsolete. However, if a factory is built near the property, even if there are no negative health or safety factors, the quality of life will suffer due to an increase in noise, odor, or other factors. Such developments may make it difficult to market the property and cause it to become obsolete in the local market.

3. Local Economic Conditions

Local economic conditions that can affect a project's viability are generally addressed in the market study and generally cannot be fixed through any changes to or investments in the property. For example, if a community lacks sufficient transportation, medical, and school systems or if the local neighborhood has changed in character so that it is no longer a desirable residential site, the project may be rendered obsolete:

4. Need

Before making a final determination on whether the property is obsolete, the Loan Servicer must consider if there is a need for the project. A determination of need does not influence whether the property is obsolete, but it may influence the Agency's response to a finding of obsolescence.

The Loan Servicer determines the need for the project, with an emphasis on determining if a non-program designation will have an adverse impact on tenants, in accordance with Paragraph 6.5.

C. Determination

For health or safety issues, physical characteristics, or economic conditions related to the building or site, the Loan Servicer must document that the condition does exist and one of the following statements is true in order to declare the property obsolete.

1. The issue cannot be resolved through special servicing, workout agreement, or a subsequent loan;

2. The total cost to resolve the issue, including subsequent loans and special servicing, is greater than the cost of building a new project; or

3. The size of the rehabilitation loan, or other financing, makes the project economically unviable.

For example, in the scenario of a property unknowingly built on poor soils, the physical inspection and core soil sample can confirm the threat to tenants and damage to the property. The Loan Servicer will need a professional to determine if the problem can be corrected and provide a cost estimate.

If the problem can be resolved, the Loan Servicer must determine the total amount of a subsequent loan plus any increased rental assistance, write-off amount, or other special servicing costs. For example, if the property requires a rehabilitation loan of $1 million, and a debt write-off of $500,000, and the cost of new construction is $1.4 million, it is not in the Agency's financial interest to fund the rehabilitation.

The professional may state that the foundation may be repaired at 60 percent of the cost of new construction. However, if the property currently struggles to make the necessary loan payments, rents are as high as the market and program policies allow, and no rental assistance or other special servicing funds are available, the additional debt may make the project economically unviable.

6.7 DETERMINING IF THE PROPERTY IS SUITABLE

If the Loan Servicer determines that there is no need for the project and/or the project is obsolete, the Loan Servicer should prepare the case file with all the documentation from the suitability analysis with a recommendation and forward the analysis and recommendation to the State Office. The State Office may seek advice from OGC and the National Office as necessary to determine if it agrees with the Loan Servicer's analysis and recommendation. If the State Office determines that a borrower should be offered prepayment, the State Office must send the suitability analysis to the National Office for approval. If the Loan Servicer's analysis indicates that the project is suitable, the Loan Servicer may proceed with the servicing action and does not need to forward the case file to the State Office.

A. Tenant Notification

When the Loan Servicer sends the case file to the State Office, the Loan Servicer should provide written notification to the tenants informing them that the Agency is reviewing the project's suitability. The Agency should hold a meeting with the tenants to explain the implications of a possible non-program designation and explain how the process will proceed. Additional notifications should be provided to tenants when the Agency makes a final determination and, if applicable, when a final date has been set for designating the property as non-program.

B. No Longer Suitable Determination

In making its determination of whether a property is no longer suitable, the State Office should consider how the factors of need and obsolescence influence the Agency's decision. There are four possible outcomes when considering these factors as outlined in Exhibit 6-4:

Exhibit 6-4

Determining if a Property is Suitable

There are four possible combinations of whether there is a need for a property and whether the property is obsolete.

1. If there is a need for the project and the property is not obsolete, the property is suitable.
2. If there is a need for the project and the property is obsolete, then the property is no longer suitable.
3. If there is no need for the project and the property is not obsolete, the property is no longer suitable, and prepayment, with National Office approval, is the preferred outcome.
4. If there is no need for the project and the property is obsolete, the property is no longer suitable.

If the Agency determines that the property is no longer suitable to remain in the program, then the Agency must determine if the property should be designated as a non-program property or a different course of action is more appropriate.

C. Borrower Responsiveness

The State Office should consider what, if any, role the borrower played in creating or perpetuating the need or obsolescence problem. The State Office should also consider borrower responsiveness in trying to overcome suitability problems. A finding that a project is no longer suitable and the resulting decision to designate the property as a non-program property should be used primarily when the suitability problem was not intentionally caused by the borrower and the borrower made a good faith effort to overcome the problem. However, when it is in the Agency's best interest, the Agency may make a non-program designation if the borrower was responsible for or unresponsive to the problem. The Agency should minimize any financial gain such a borrower may receive through a non-program designation.

D. Other Factors

The Agency may determine that even though there is no need for a project or the property can be considered obsolete, it is in the Agency's best interest to keep the property in the program. In most cases, the Agency is making a decision to continue to put resources into the property in order to maintain it as a suitable program property. Such factors that may lead to this decision include when there is a significant negative impact on a community, which the Agency cannot mitigate without undue expense, or when a non-program determination is not in the Agency's best interest.

E. Take a Different Course of Action

The Agency may determine that if a property is no longer suitable for the program, it is in their interest to take a different course of action, rather than declaring a property as non-program. The Agency may:

- Continue with special servicing actions, including developing a workout agreement in accordance with Chapter 10;
- Request the borrower to transfer the property in accordance with Chapter 7;
- Consider changing the use of the project. A change from family housing to elderly, a change to congregate or cooperative housing, for example, may provide a positive opportunity for salvaging a project and serving the community;
- Request the borrower to change the management agent in accordance with Chapter 3 of HB-2-3560; or
- Initiate liquidation in accordance with Chapter 12.

6.8 REGULAR VS. EXPEDITED REVIEW

A. Preliminary Determination

For both the questions of need and obsolescence, the Loan Servicer determines whether to conduct a regular or expedited review. For example, the Loan Servicer may determine that no review of obsolescence is necessary, but feels that a full review of need is required. Another option may be to conduct an expedited review of need and a full review of obsolescence factors. In all cases, the Loan Servicer must consider the impact on the tenants.

B. Regular Review

A regular review is most appropriate when the Loan Servicer does not have sufficient information on the suitability problems to make a determination. A regular review allows the Loan Servicer to obtain the necessary documentation so the Loan Servicer has a full understanding of the suitability issues and can conduct an in-depth analysis to recommend the most appropriate outcome. Among the issues the Loan Servicer must have sufficient documentation on to determine suitability are:

- What is the nature of the suitability problem or issue?
- What would be the impact on tenants if the property were removed from the program?

- Is the suitability problem permanent or short-term?
- Will special servicing resolve the problem?
- What is the availability of resources, such as rental assistance, subsequent loan funds, and owner funds?
- What actions has the borrower taken to resolve the problem?

If the Loan Servicer cannot answer these questions and show supporting documentation in the case file, the Loan Servicer should conduct a regular review.

C. Expedited Review

An expedited review is most appropriate when the Loan Servicer already has significant documentation on the suitability problem and the resolution is readily apparent. For example, if the Agency has documentation that a property was unknowingly built on sand and the damaged foundation is causing a significant health and safety threat to tenants, an expedited review may be appropriate. In this situation, while it may be apparent that the property in no longer suitable, the process of implementing the decision and ensuring that all tenants find alternative housing that is affordable, adequate, and appropriate, may be a difficult and time-consuming process.

To conduct an expedited review, the project should meet the following criteria:

- The Agency has substantial documentation on the project's suitability issues;
- The outcome of the analysis is readily apparent and independently verifiable; and
- The cause of the problem and the suitability outcome determination will likely not be disputed.

6.9 CHANGING A PROJECT'S DESIGNATION TO NON-PROGRAM

To implement the determination that a program is no longer suitable, the State Office must act in a manner to protect the Agency and the property's tenants. The basic steps in the process of designating a property as non-program when there is an adverse impact on tenants are the same as when there is no adverse impact. However, when there is an adverse impact, the Agency will need to take additional measures to ensure that all tenants receive decent, safe, and affordable housing. This process of assisting tenants will likely delay the implementation of a non-program designation.

A. Determine Implementation Plan

In making a determination of the most appropriate means to remove a property from the program, the Agency must balance the following interests:

- Act in the financial interest of the Agency by obtaining the greatest net recovery;

- Act to protect the interest of the tenants by ensuring they have decent, safe, and affordable housing; and

- Act to protect the integrity of the program by ensuring that the non-program designation does not provide undue rewards to the borrower.

Based on these interests, the Agency must choose the most appropriate of the following options to remove the property from the program:

- Allow the borrower to prepay the loan in accordance with Chapter 15. The National Office must approve all prepayment agreements;

- Allow the borrower to retain the property as a non-program property and repay the loan on non-program rates and terms.

B. Assist Tenants

Based on the impact of the non-program designation on tenants, the Agency must assist all tenants to find decent, safe, and affordable housing in the area of the project. Even if there should be no adverse impact on tenants, the Agency should work with all tenants to ensure that everyone is properly housed. All tenants must have decent, safe, and affordable housing before the Agency designates a property as a non-program property. The Agency should take the following steps to assist tenants, as necessary.

- Work with other federal, state and local agencies to find alternative housing and subsidies;

- Provide *Handbook Letter 201 (3560), Letter of Priority Entitlement (LOPE)* letters to tenants. If tenants have RA, the RA may be transferred with the tenant to any other eligible project; and

- Provide other assistance and guidance, as appropriate, to assist tenants find alternative housing.

C. Designate the Property as Non-Program

After all tenants are assured of continued decent, safe, and affordable housing, the Agency may complete the chosen means of implementation and designate the property as non-program. The State Office should work with the National Office, OGC, and the St. Louis Office, as necessary, to complete the appropriate transactions.